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GUIDELINES FOR IMPROVING THE  
INTERNATIONAL MONETARY SYSTEM

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REPORT

OF THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE  
AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE  
CONGRESS OF THE UNITED STATES



Printed for the use of the Joint Economic Committee

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## LETTERS OF TRANSMITTAL

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AUGUST 30, 1965.

*To the Members of the Joint Economic Committee:*

Transmitted herewith for the use of the members of the Joint Economic Committee and other Members of Congress is a report of the Subcommittee on International Exchange and Payments on Guidelines for Improving the International Monetary System.

The views expressed in this subcommittee report do not necessarily represent the views of other members of the committee who have not participated in hearings of the subcommittee and the drafting of its report.

WRIGHT PATMAN,  
*Chairman, Joint Economic Committee.*

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AUGUST 27, 1965.

HON. WRIGHT PATMAN,  
*Chairman, Joint Economic Committee,  
U.S. Congress, Washington, D.C.*

DEAR MR. CHAIRMAN: Transmitted herewith is the report of the Subcommittee on International Exchange and Payments on Guidelines for Improving the International Monetary System.

The subcommittee wishes to express its gratitude and appreciation for the guidance it has received from the experts who appeared before it as witnesses or who submitted materials in writing.

HENRY S. REUSS,  
*Chairman, Subcommittee on  
International Exchange and Payments.*

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# **GUIDELINES FOR IMPROVING THE INTERNATIONAL MONETARY SYSTEM**

## **REPORT BY THE SUBCOMMITTEE ON INTERNA- TIONAL EXCHANGE AND PAYMENTS OF THE JOINT ECONOMIC COMMITTEE**

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### **I. THE PRESENT WORLD MONETARY SYSTEM**

The present international monetary system is a highly developed form of the gold exchange standard. It has evolved partly through the practices of international traders and financiers and partly through the design of governments. The essential features of this standard are that exchange rates are stable, though alterable in instances of fundamental disequilibrium, and foreign currency holdings supplement gold in the international reserves which provide the means for maintaining exchange rate stability. These features reflect the strong preferences of traders and investors for exchange rate stability, so that their international dealings may be free of a dimension of risk not found in domestic transactions. These features also reflect the convenience of holding balances, both official and private, in the currencies of countries with dominant positions in world trade and finance.

The gold exchange standard came into widespread use in the stormy period between the two World Wars, although limited instances of its use date back to the 18th century. Sterling, which had been the world's leading trading currency before 1914, was at first the pre-eminent reserve currency. But its devaluation in 1931 brought this worldwide preeminence to an end and narrowed sterling's domain to a group of countries known as the sterling area. Gradually, through the turmoil of the 1930's, the dollar came to be more widely used as a reserve currency. After World War II, the dollar became the principal supplement to gold in international reserves. The extraordinary reliance of a war-devastated world on the United States for trade and aid and the strong reserve position of this country made the dollar appear impregnable as a reserve asset.

Large quantities of dollars became available in the postwar years through deficits in the United States balance of payments. These deficits, which have been a cause of concern in recent years, were welcomed in the early part of the period. They permitted the war-devastated countries to rebuild their international reserves, promoted a better distribution of the world's monetary gold stocks, and made possible the return to convertibility of the major currencies.

The postwar international monetary system was buttressed by the creation of the International Monetary Fund (IMF). The Fund provided a set of rules for international financial conduct, machinery for consultation and cooperation, and financial resources for countries in temporary balance-of-payments difficulties.

## II. DEFICIENCIES OF THE PRESENT SYSTEM

By the end of the 1950's, a number of deficiencies of the system were increasingly recognized:

(1) While credit facilities, including the IMF, have been effective in lending reserves to individual countries in the short run, the system provides no mechanism for assuring that world reserves will increase as needed in the long run. The growth of world reserves depends on fortuitous developments in gold production and private hoarding, and on the balance-of-payments circumstances of the reserve currency countries. Even if all new gold production were channeled into monetary reserves, growth of gold stocks would be too slow to meet world needs. The balance-of-payments deficits of the reserve currency countries cannot be depended upon as a substantial, continuing source of liquidity because they are not primarily related to the world's needs for reserves. These deficits sooner or later impair confidence, reduce the willingness of other countries to add to their holdings of the reserve currencies, and bring pressure on the reserve currency countries to end their deficits.

(2) Apart from the adequacy of reserve creation, the system suffers from the danger of instability. The reserve currency countries can be placed under severe pressure—even threatened with involuntary devaluation—by sudden liquidations of the large balances of their currencies accumulated by the monetary authorities of other countries. If such a devaluation were to occur, the entire international monetary system would be severely disrupted because a reserve currency, once devalued, loses general acceptability as an international reserve asset. But without the foreign exchange component of international liquidity, present world reserves would shrink by more than one third.

(3) The process of adjustment, which eliminates international payments imbalances, is unsatisfactory. The free market forces which normally would operate to restore international equilibrium are today blunted by national policies designed to insure domestic price stability and maximum employment. Indeed, these objectives are often pursued through policies which intensify international imbalances. Non-reserve-currency countries are reluctant to resort to exchange rate adjustments even in instances of fundamental disequilibrium. Pressures for the restoration of balance-of-payments equilibrium fall unequally on deficit and surplus countries. A country's capacity to incur deficits is limited by the size of its reserves and borrowing power, but there is no comparable limit on surpluses. As a result, the burden of adjustment falls especially heavily on deficit countries, which may adopt trade restrictions and capital controls detrimental to the international economy as a whole.

Recognition of these deficiencies has not yet led to a general consensus on the direction and form which further improvement in the international monetary system should take. The system has provided a relatively steady rate of growth in world reserves since 1959, and the surplus countries of continental Europe have indeed had a very high rate of reserve accumulation. This has been achieved, however, in large part through United States balance-of-payments deficits. The IMF has increasingly demonstrated its capacity to contribute to liquidity through its credit facilities as needed, and its resources have been increased. New bilateral and multilateral arrangements have

evolved for promoting international monetary stability.<sup>1</sup> All of this machinery has strengthened the system and enhanced its capacity to meet speculative pressures on particular currencies. But whether singly or in combination the new elements, in their present state of evolution, do not provide an adequate answer to the problem. The system has continued to rely for new reserves mainly on the dollar and gold.

### III. THE NEED FOR ACTION

The need for action is pressing. Partly as the result of large gold sales by the United States, total free world reserves declined in the first half of 1965, after many years of continuous growth. As the United States succeeds in bringing an end to its balance-of-payments deficit, it will shut off the major source of new international reserves of recent years. From the end of 1958 to the end of 1964, total free world reserves rose \$11.2 billion: \$2.8 billion of this increase was gold; \$6.8 billion was foreign exchange—\$4.7 billion of it dollars; and \$1.6 billion was the increase in automatic borrowing rights at the Fund. The United States dollar provided nearly half of the total increase in free world reserves during the period. While United States reserves decreased, the reserves in the rest of the free world increased by \$17.2 billion.

Increases in Fund quotas cannot, in themselves, fully meet the needs of the future. Under the Articles of Agreement, members gain no direct increase in their reserves from quota increases, for their additional automatic drawing rights are exactly offset by a required transfer of gold reserves to the Fund. This year's increases in Fund quotas suffered from the further drawbacks that they were too small in general, and that countries in strong balance-of-payments and reserve positions, in particular, should have agreed to accept larger quota increases than they did. Despite the expansion of world trade by more than 50 percent since Fund quotas were last increased, the quota increases now being implemented will contribute no more to free world liquidity than the quota increases of 1959.

In its 1965 report on increasing the International Monetary Fund quota of the United States, the House Banking and Currency Committee stated:

In the face of the continuing expansion of international transactions and the declining contribution which dollars can be expected to make to liquidity, an increase in Fund credit facilities no greater than was provided in 1959 is clearly inadequate.

The problem remains of assuring the orderly and adequate expansion of international liquidity.

Not only the need, but the urgency of acting promptly is gaining recognition. Former Secretary of the Treasury Dillon said in an address on June 14, 1965 that the ending of United States balance-of-payments deficits means that " \* \* \* the free world \* \* \* is rapidly approaching a financial crossroads. There is an urgent need to strengthen the international monetary system so as to insure that the needed increases in reserves will be forthcoming. For inadequate

<sup>1</sup> These include swap arrangements, special Treasury bonds—the so-called "Roosa" bonds, the Fund's General Arrangements to Borrow with the Group of Ten, the London gold pool, and policy consultation and coordination through the OECD, the BIS, and other groups.



growth in international liquidity would hamper world trade, slow up the economic growth of individual countries, and threaten a worldwide recession." Mr. Dillon went on to say: "There is plenty of time to consider the issues fully and carefully so that we may act wisely. But there is no longer any time to dally. A strengthened international monetary system must be installed before it is needed and not after the crash."

On July 10, 1965, Mr. Dillon's successor as Secretary of the Treasury, Mr. Henry H. Fowler, announced that "\* \* \* the United States now stands prepared to attend and participate in an international monetary conference that would consider what steps we might jointly take to secure substantial improvements in international monetary arrangements." Mr. Fowler stated that, with the help of a newly created Advisory Committee on International Monetary Arrangements and the help of others, "\* \* \* we shall constantly seek a comprehensive United States position and negotiating strategy designed to achieve substantial improvement in international monetary arrangements thoroughly compatible with our national interests."

#### IV. STUDIES BY THE COMMITTEE AND SUBCOMMITTEE

Our subcommittee was early to recognize the need and the dangers. Our report of 1961, "International Payments Imbalances and Need for Strengthening International Financial Arrangements," examined the requirements of an effective international monetary mechanism and recommended a supplementary credit agreement within the IMF among the principal industrial countries. A year later, our report "United States Payments Policies Consistent With Domestic Objectives of Maximum Employment and Growth" recommended that the United States should take the leadership in establishing a mechanism which can add to international reserves. The Joint Economic Committee's extensive report in 1964 on the United States Balance of Payments recommended that the free world must proceed now to devise ways and means for improving its financial organization and expanding international liquidity.

The Subcommittee on International Exchange and Payments has, through its current hearings and studies, participated in the work of building toward an improved international monetary system. We have set ourselves and our witnesses the task of developing detailed guidelines for international monetary reform that are operationally useful and clearly define the direction in which reform should move. We have tried to address ourselves directly to those changes in the system which are in the realm of the possible, and to avoid those changes which are so much opposed both in the United States and abroad that they stand no reasonable chance of adoption. We have therefore, for example, not considered flexible exchange rates. Nor have we explored changing the price of gold—a course which we opposed in earlier reports and continue to oppose on principle. We have focused on strengthening existing institutions, on the possibilities of supplementing them in new ways, providing them with new features, or changing the relative importance or "mix" of the various elements that together make up today's international monetary system.

As a result of our work, we recommend the following guidelines for strengthening the international monetary system:

## V. GUIDELINES

### 1. World liquidity needs cannot adequately be met by existing sources of reserves (gold, dollars, and pounds sterling) or even by the addition of new reserve currencies. New ways of creating international reserves must be sought.

We have already noted the self-limiting aspects of the present international monetary system—that increases in dollar and pound sterling reserves cannot adequately fill the gap between long-term liquidity needs and probable increases in monetary gold stocks. Such reserves are generated through deficits in the balances of payments of the two reserve currency countries. Sooner or later these deficits impair confidence and reduce the willingness of other countries to increase their foreign exchange holdings, or even to continue holding previously acquired balances.

The limits of the present system could be somewhat expanded through a modest and limited evolution of other national currencies to reserve status. But this path should not be our main road toward international monetary reform. The dangers of instability resulting from possible shifts among reserve assets might multiply with a proliferation of such assets. To guard against these dangers, any new reserve currency country might wish to limit carefully the growth of official liabilities in relation to its reserves. Existing reserve currency countries might feel constrained to reduce or consolidate their liabilities to foreign central banks. These considerations limit the potential contributions to liquidity of a larger number of reserve currencies. Moreover, few currencies suggest themselves as immediate candidates for the new role. Monetary history makes somber reading. What currencies have a record of domestic and international stability that can rival the dollar's? The question of confidence is underscored by the manner in which foreign exchange reserves are generated in this system—through deficits in the balances of payments of the reserve currency countries. It seems questionable that countries without histories of monetary stability could incur balance-of-payments deficits of any substantial size and duration without sharply impairing the willingness of monetary authorities elsewhere to hold their currencies as international reserves. Finally, enlargement of the number of reserve currencies would not assure a more rational process of liquidity growth; there would still be no guarantee that reserves would increase as needed.

We emphasize that the limitations of a multiple reserve currency system do not militate against some evolution of such a system but only against substantial reliance upon it to meet future needs. The United States already has suggested that it might cushion the effect on liquidity of its future balance-of-payments surpluses by accumulating the national currencies of other countries. This would be an initial step toward such a system. There is much to be said for it—as a supplement to more dependable techniques for increasing world liquidity.

Our discussion of present methods of increasing reserves would be incomplete without mention of the limited role of the Fund today in enlarging aggregate world reserves. Net additions to the total of world reserves can come about as an incidental consequence of some

Fund lending operations. The additions take the form of extra automatic drawing rights at the Fund, not fully offset by reductions in automatic drawing rights or other forms of reserves elsewhere in the system.

This source of increased aggregate reserves has not been large in the past because Fund transactions have been small in relation to international payments imbalances, total reserves, and world trade. Moreover, not all Fund lending operations augment total world reserves.

If the major countries used the Fund as a primary means of financing their balance-of-payments deficits, net reserve creation would be large. But of the leading industrial countries only the United Kingdom has relied heavily on the Fund in recent years. Fund operations have mainly involved the less developed countries, whose international transactions are dwarfed by those of the industrial world. Thus, while the Fund is capable of adding substantially to world reserves, it has not yet been used to its full potential.

We recognize, of course, that reserves in the sense of owned reserves are not the sole aspect of liquidity. The ability to borrow reserves when needed under credit facilities is also important. While the operations of the Fund through 1964 contributed only a moderate amount to the creation of owned reserves, the Fund has made a highly significant additional contribution to world liquidity by providing conditional credit availability to all members. However, as we explain later in this report, the expansion of conditional credit facilities is not a satisfactory substitute for the expansion of owned reserves. On the other hand, expansion of world reserves through increases in automatic drawing rights at the Fund is one of the major alternatives for the future.

The deficiencies of the existing system—particularly its inability to assure the adequate growth of reserves—compel the conclusion that new sources of liquidity must be developed.

- 2. The United States should seek neither to expand nor reduce the international role of the dollar.**  
At the same time, we must work for a plan for new reserve creation that would not encourage or require countries to convert existing balances or new acquisitions of reserve currencies into gold or the new reserve medium. In this way, the dollar will continue to play an important, perhaps even a growing, international role, according to the voluntary decisions of traders and bankers abroad.

- A. The role of the dollar in private transactions will be unimpaired, even if foreign monetary authorities choose to reduce their dollar reserves.*

It is essential to distinguish between the dollar as an official reserve currency and the dollar as the principal medium of exchange in private international transactions. The dollar's official reserve role evolved from its private transactions role. In this sense, the two roles are related. But continuing the private transactions use of dollars is not dependent on maintaining the dollar as a reserve currency. Indeed, the demand for dollars in private transactions is so strong, and

likely to remain so, that we believe direct interference by national governments would be required to displace it.

The dollar has grown in importance as a private payments currency for two principal reasons: (1) the broad scale and efficiency of United States money and capital markets has encouraged and facilitated the use of dollars for trade financing. This has given American banks and other financial institutions a leading position in international finance; and (2) the dollar has proved highly useful as a vehicle or intermediary between other currencies. With some 110 distinct currencies in the world, the absence of a vehicle currency would imply some 12,000 different bilateral currency markets. The use of the dollar as an intermediary enables traders to shift from one currency to another through dollars, thus preventing the clogging up of international transactions by cumbersome barter among many currencies. Foreign monetary authorities also use the dollar as the medium of exchange in maintaining exchange rate stability by buying and selling their own currencies against dollars in foreign exchange markets.

The use of dollars in official reserves came about as a consequence of their importance in private transactions. Central banks found it convenient to acquire substantial balances of a currency which they use for intervention in foreign exchange markets and which have the further advantage of earning interest. But even if these banks now chose to cut back on their dollar reserves, the private transactions demand for dollars would continue to grow with the world economy.

***B. The demand for the dollar as an official reserve medium is likely to remain high.***

The reserve currency role of the dollar has been of some benefit to the United States in the past, and could be again in the future, although on a more limited scale. The United States should not seek to reduce this role. We are confident that the dollar will continue as an important international reserve medium if we avoid inflation of prices in the United States, and if we prevent the dollar from being deliberately undermined by prejudicial features of new arrangements.

Obviously, the interest of all the industrial and trading nations of the world is in assuring an orderly expansion of international reserves. This can hardly be accomplished if the new arrangement itself encourages sudden and large-scale conversions of dollars into our gold stocks. Such conversions would intensify the pressures on the United States and result in an actual diminution of international liquidity.

Moreover, the United States must oppose any arrangement which would commit central banks to liquidating their dollar reserves. Under the present system, the monetary authorities of each country are free to decide upon the composition of their international reserves—what part is to be gold and what part reserve currencies. To be sure, the gold exchange standard could not function if monetary authorities were unwilling to hold foreign exchange in their reserves. But, within broad limits, the management of international reserves is discretionary. Foreign central banks holding dollars do so voluntarily, for they could convert them into gold if they preferred.

We regard voluntary holding of the dollar by foreign central banks as desirable. This voluntarism should not be abandoned. National monetary authorities should continue to be free to manage the composition of their reserves as they see fit.

Voluntarism implies the risk that some countries will wish to convert large dollar accumulations into gold. France has already done so in a dramatic manner. Other countries, in a less dramatic manner, have acquired substantial amounts of gold. But if the United States continues to make satisfactory progress toward the elimination of its balance-of-payments deficit (on the official settlements definition), foreign official demand for dollars probably will rise. Indeed, even today, most countries would be pleased to hold more dollars in their official reserves than they now have. Only a handful of countries have been concerned about an excess supply of dollars. And these, no less than the others, need working balances of dollars for intervention in foreign exchange markets.

The United States has succeeded in funding some of the excess supply of dollars with medium-term "Roosa" bonds which provide, in effect, exchange rate guarantees. We would favor some expansion of this technique for reducing the excess supply of dollars where it exists.

We do not believe that the dollar can or should contribute as much to international liquidity in the future as it has in the past. However, we see no need to worry about its future as a reserve medium if our balance-of-payments deficits are brought under control. The administration has stated repeatedly, and we concur, that the Nation's objective in international monetary reform is not to find a device for enabling the United States to finance balance-of-payments deficits painlessly. If the United States ends its deficits, the dollar will take care of itself.

Unfortunately, the international monetary system will not take care of itself. International monetary reform is necessary and urgent precisely because the prospect of an end to dollar deficits, the major source of international reserves in recent years, threatens to lead to a liquidity shortage. With respect to the future of the dollar, the United States objective in the coming negotiations should only be to prevent the creation of new difficulties, not to seek new guarantees or commitments concerning dollar holdings.

- 3. Gold should continue its present role as a universal medium of international exchange. The United States should not seek to undermine it. But nothing must be done to enhance its value in relation to other forms of reserve assets; no arrangements can be acceptable that provide incentives to convert reserve currencies into gold.**

Gold has a long history as a monetary metal. Some of us believe that the mystique of gold is largely a fiction, but none of us would dethrone gold in building toward a better international monetary system. Allowing it to continue in its present role need not impede progress toward our goals.

Replacing gold would raise important practical problems. Gold presently constitutes nearly 60 percent of total free world international reserves. The United States holds more than \$14 billion, or one-third, of all free world monetary gold. To replace gold would clearly be difficult in view of its important place and the traditional strong gold preferences of the world's monetary authorities. No doubt, ways of doing so could be devised. However, we would prefer to focus the

weight of the United States bargaining position on proposals that are clearly essential to progress, rather than diffuse it by insisting on a broad range of proposals, some of which would be both highly controversial and nonessential.

Newly mined gold and possibly gold from private hoards will add to international liquidity in the future. But gold will diminish in importance relative to other international reserve media, because this growth will fall increasingly short of meeting international needs. The relative decline of gold as a monetary asset has characterized the evolution of national monetary systems as well as the international system. So long as a mechanism for assuring an adequate growth rate for total international reserves is developed, there need be no concern whether the relative role of gold is greater or smaller in the future than in the past.

We are opposed to any increase in the price of gold. Such a step would amount to a devaluation of the dollar. Whether the United States acted alone or in concert with other nations, the devaluation would reward those countries most who had cooperated least, greatly damage the dollar as a reserve currency, reward and provide new incentives for gold speculators, benefit Russia and South Africa, and do little or nothing to help the countries with low reserves who badly need additional liquidity.

In the forthcoming negotiations, the primary concern of the United States must be to avoid creating a larger role for gold at the expense of the reserve currencies. Gold presently competes with reserve currencies for a place in the reserves of individual countries. It offers its holders both advantages and disadvantages relative to the other reserve media. The advantages must not be enhanced.

**4. The new method of reserve creation should combine agreed minimum annual increases with supplements to be determined by annual decision.**

Agreement on appropriate increases in liquidity may not always be possible among the countries concerned. But lack of agreement on the exact amount of liquidity needed should not preclude an agreement to increase liquidity periodically in minimum amounts.

We favor regular, annual additions to liquidity through the new method. This could be achieved by dividing annual increases into two parts. (1) The automatic part should be clearly noninflationary and modest in relation to the rate of growth in world trade. It might be related to the rate of increase in world exports in the most recent year, to a moving average of world exports, or to other economic variables. (2) The discretionary part would consist of an additional amount to be agreed upon, so that the overall rate of increase in liquidity would be adequate, taking into account the growth of international reserves from other sources and all other relevant considerations.

**5. The new arrangements should be carried out under the International Monetary Fund.**

The United States must strive for more rational organization as well as for more dependable reserve creation. The IMF has already proved its usefulness and flexibility. Its record of accomplishments and the high stature of its management have endowed it with respect and esteem. The Fund has a broad membership, including the less

developed as well as the industrial countries. It has an expert staff and many years of experience. It already exists and operates, and could immediately undertake new functions. There are important advantages in having new reserve creation and the administration of conditional credit facilities centered in the same agency. It would be unwise, therefore, to create a new organization which could not fail to detract from the Fund by duplicating some of its functions and responsibilities.

**6. Newly created reserves should be distributed to all Fund members who qualify under criteria applicable equally to all countries.**

We oppose the creation and distribution of new reserves within an exclusive group of financially powerful countries. As a general rule, the system for new reserve creation should be open to all members of the Fund, but criteria should be established and applied equally and universally so that only those meeting minimum standards of international financial conduct would receive the immediate benefit of the new reserves. Such standards might include convertibility of the currency of the country concerned and the absence of indebtedness to the Fund above some level related to the country's quota in the Fund. We would favor distributing the new reserves to qualifying countries in proportion to their Fund quotas, adjusted as recommended in our guideline 10.

The needs of individual countries that cannot be met from their reserves, increased according to the above guideline, should in general be satisfied by conditional credit facilities. A long-term program for increasing world liquidity in response to world needs should not have as its primary focus the particular needs of individual countries. Providing the new reserves necessary for the system as a whole initially to the countries in balance-of-payments deficit would greatly reduce their incentives for taking proper measures to correct their deficits.

In addition to distributing new reserves to member countries according to criteria applicable equally to all, the system should provide for selective distributions from time to time, either through weighted voting among Fund member countries or at the circumscribed discretion of the Fund's Managing Director. A first example would be selected increases in the reserves of individual countries if such increases would contribute substantially to international monetary stability. A precedent for such selective increases was provided by Fund investments of \$800 million in the United States, paid for with an equivalent amount of gold.

A second example would be selective increases in reserves for countries who have restored equilibrium to their international accounts, but whose reserves are so low that desirable domestic policies are unduly constrained by the fear of further reserve losses.

In sum, we conclude that, in the main, all countries should benefit from the creation of new reserves, according to certain qualifying criteria applied equally and universally. But this should not be an

ironclad, rigid rule precluding selective reserve increases in special, limited circumstances.

7. **While the new reserves cannot be used as a primary foreign aid device, because securing them by the credit of less developed countries might impair their acceptability, economic development can be respected by selecting suitable standards for allocating the new reserves.**

After sympathetic consideration of the special needs of the less developed countries, we conclude that new reserve creation should not be used as an important device for providing economic assistance. However, we also conclude that the need for reserves is not limited solely to those countries which are generally regarded to be industrially developed. In recent years, many less developed countries have expanded reserve holdings. As further progress is made, their ability to participate in growing world trade will depend on their ability to share in the growth of world liquidity. The important distinction is between the need for reserves and that for capital; and for the less developed countries generally a shortage of liquidity is often symptomatic of a more basic and serious capital shortage frequently intensified by inflation.

While developing countries should not be excluded from a system for creating reserves, the system should not aim at meeting their needs for long-term development capital. We therefore do not favor proposals to link closely the creation of new international monetary reserves with long-term foreign aid to less developed countries. This might be done either by having the IMF distribute substantial portions of the new reserves directly to less developed countries for their long-term capital needs, or by delegating this function to the World Bank through IMF purchases of large quantities of World Bank bonds with newly created reserves which the World Bank would then distribute to less developed countries. We regretfully find ourselves unable to endorse these proposals for four reasons:

1. To the extent that foreign aid considerations played a part in reserve creation, there would be a tendency to expand international reserves beyond the requirements of the international monetary system.

2. Any close linkage of international reserve creation with foreign aid would tend to make improved international monetary arrangements more difficult to achieve by making international monetary reform a back door for foreign aid commitments that developed countries might not be willing to make directly. We express below our hope that the developed countries will agree on a greatly expanded program of development aid to the less developed countries. But the problem of aid should be approached on its own merits. The needs of the international monetary system cannot be judged by aid criteria.

3. The purpose of creating new international reserves is to provide countries with funds for maintaining exchange rate stability and liberal payments policies. International reserves are, in this sense, a special form of money. As the Ossola report noted, "A reserve asset



is characterized by the expectation that, if it flows out, it should ordinarily be reconstituted in due time." If the new reserves are promptly spent by countries for long-term capital development, with little or no intention of reconstituting them, the new reserves have not served their proper function.

4. The acceptability of international reserve assets may be impaired in the eyes of some countries to the extent that they are secured by the credit of less developed countries.

However, the less developed countries should get some direct benefits from overall reserve creation. We believe that their legitimate requirements can be met fairly, and the asset base of new reserves protected, by limiting the immediate benefits of new reserve creation to countries meeting suitable minimum standards of international financial conduct. Moreover, an improved international monetary system will itself facilitate the transfer to them of real resources. But our primary response to the special problems of these countries must take the form of other programs, more directly tailored to the underlying needs. We favor a generous program of assistance to these countries, including, but not necessarily limited to, grants, long-term loans at low rates of interest, technical assistance, and programs to broaden markets for their products.

**8. The International Monetary Fund can create new international reserves by developing a new reserve unit or claim, making drawing rights more automatic and larger in amount without requiring additional gold deposits, or by special operations in currencies, gold, or deposits. In choosing among these possible methods, the distinction between owned and borrowed reserves should not be critical.**

A number of different approaches have emerged in the search for new methods of creating international reserve assets. They have been explained comprehensively in the "Report of the Study Group on the Creation of Reserve Assets," the so-called Ossola report, which was released on August 10, 1965. In brief, a new reserve unit could be created through the deposit by member countries of their own currencies or special government obligations with the Fund, in agreed-upon amounts and proportions. The member countries would be credited with equivalent amounts of new reserve units. Alternatively, automatic drawing rights of Fund members could be increased without requiring offsetting deposits with the Fund of gold reserves. This could be achieved by extending the right to draw automatically to what is now the first credit tranche, increasing annually the percentage of quota subject to automatic drawing rights, or allowing countries to pay with gold certificates instead of with gold on the occasion of quota increases. Automatic drawing rights could be made directly transferable among countries.

Special operations by the Fund offer further alternative approaches to reserve creation. The Fund could invest national currencies in member countries, acquiring in return special governmental obligations or obligations of international agencies such as the World Bank; the national currencies to be invested could stem either from the Fund's existing holdings or be borrowed from member countries in exchange

for special Fund obligations which would qualify as international reserves. The Fund could invest its own gold reserves in member countries, thereby raising their reserves. Finally, the Fund could accept deposits of national currencies from countries on a negotiated basis, giving them in exchange claims on the Fund that qualify as international reserves.

These alternatives can be divided into two groups—one providing new owned reserves and the other additional automatic drawing rights at the Fund. Can this distinction help in the choice of method?

Some of our witnesses expressed a strong preference for the creation of owned reserves over the expansion of automatic drawing rights. They pointed out that the use of automatic drawing rights involves borrowing, and they emphasized that borrowing is inherently inferior to the use of owned reserves; countries may be reluctant to submit to conditions or assume contractual obligations related to borrowing, and may consequently follow unduly deflationary policies.

We recognize the essential difference between owned reserves and automatic lines of credit; the use of credit, no matter how automatically it is available, usually involves contractual obligations to repay according to a stipulated time schedule, while the depletion of owned reserves carries no external commitments as to reconstitution. If used, owned reserves may have to be replenished, but that is discretionary as to amount and timing, not contractual. We conclude, however, that automatic lines of credit can be made equivalent to owned reserves.

If it can be said today that countries hesitate to borrow, it is equally true that they are reluctant to permit any significant reduction in their owned reserves. Normal reporting requirements focus much more on changes in owned reserves than on drawings or borrowings. The examples of Canada and Italy, among others, indicate that at least some countries prefer to borrow than to see any substantial impairment of their owned reserves.

The gold tranche position of the Fund members today represents their virtually automatic drawing rights at the Fund. Up to the limits of this position, members are given the overwhelming benefit of doubt with respect to drawings. To remove any question about the automaticity of these rights, we believe that they could be made fully automatic—that the “virtually” be deleted from the present statement of these rights. Moreover, the terms of repayment could be made less confining with respect to these automatic rights. Although present procedures permit the rolling over of drawings, members are generally expected to adhere to the Fund’s 3- to 5-year repayment rule. With respect to automatic drawing rights, we see some merit in eliminating the 3- to 5-year repayment rule and utilizing only the automatic repayment provisions in the Fund’s Articles of Agreement which prescribe no time limits for repayment, but require members to share with the Fund a portion of any increases in their reserves until repayment is complete. Consideration could also be given to eliminating the Fund’s present practice of levying a service charge of one-half of 1 percent with respect to drawings within the automatic line of credit. It is difficult to argue that automatic drawing rights are as good as the gold members paid into the Fund, if costs are associated with using these rights. Finally, it might even be desirable to pay members a modest yield on their automatic drawing rights with the Fund.

It may be that not all of these changes would be necessary to make automatic drawing rights fully equivalent, in all material respects, to owned reserves such as gold. But with these changes, this equivalence would certainly be accomplished.

Thus, we find that the distinction between owned and borrowed reserves need not be critical in choosing the most advantageous method of increasing reserves. M. Pierre-Paul Schweitzer, Managing Director of the Fund, placed the problem of choice in correct perspective in his June 2, 1965, address on "The International Monetary System and International Liquidity." M. Schweitzer did not provide extensive details of how the Fund could create reserves. He observed "\*\*\* as a matter of fact, these details are not very important from a broad point of view." He briefly described several alternatives and then noted:

There are technical differences among these various techniques, but in the end they are not of overwhelming importance and the primary issues to be decided are essentially these: (1) How can an equitable distribution be achieved of the additional purchasing power that is created by any international action to increase liquidity, and (2) how can the decisions on these questions be made in a manner that adequately takes account of the varying interests of countries?

Provided that the method selected meets our guidelines, and in particular does nothing to undermine the dollar, we express no preference as to which approach should be favored.

**9. The Fund's conditional credit facilities should be expanded at the same time that new reserves are created.**

Increased reserves are needed to keep pace with the growth of international transactions. The same reasoning applies to conditional credit facilities. Countries should have absolute command over some portion of international liquidity so that they can finance temporary balance-of-payments deficits without being subject to conditions imposed by creditor countries. If, however, their reserves fall short and their deficits continue, it is logical that additional financing should carry conditions as to proper policies for restoring equilibrium and that these conditions should increase in severity with the amount and duration of the financing required. The conditions should, of course, be tailored to the particular circumstances of the deficit country. It should be a basic feature of the international monetary system that it provide reasonable incentives both for deficit and surplus countries to eliminate their imbalances.

Conditional credit facilities need not increase in the same proportion as owned reserves, but a serious imbalance could result in the structure of international liquidity unless conditional credit facilities in general kept pace with the increase in owned international reserves. If reserves are increased by allowing countries to draw automatically on what is presently conditional credit at the Fund, total drawing rights would have to rise merely to preserve the present size of conditional rights. Provision should therefore be made for periodic increases in

the Fund's conditional borrowing facilities to maintain reasonable balance between them and owned reserves.

**10. A better sharing of international financial responsibilities should be achieved through an improved structure of Fund quotas.**

The present structure of quotas is clearly unsatisfactory, because increases in the quotas of certain leading countries have lagged far behind improvements in their relative economic positions in the world. As a result, the Fund's supply of strong currencies to use in its operations is unduly limited. The House Banking and Currency Committee, which earlier this year held hearings on legislation providing for an increase in the United States quota, properly criticized France, the Netherlands, Belgium, and Germany on the grounds of inadequate quota increases.

An analysis of the structure of Fund quotas, reveals that, after the current increases, the quotas of most of the Group of Ten countries (including the United States) will be in the range of 78 to 96 percent of the statistical calculations used for each country during the recent Fund negotiations. But it is interesting to observe that the average quota for the members of the Fund not participating in the Group of Ten will be about 132 percent of the comparable statistical calculation. If the quotas of all of the Group of Ten countries were, as a minimum, raised to a point comparable to those of the other Fund members, countries in the Group of Ten would require aggregate quota increases of some \$5.6 billion beyond the increases now in process, of which about half would be by countries other than the United States and the United Kingdom. Obviously such a development would greatly strengthen the Fund's resources.

We favor a closer integration of the Group of Ten lending commitments within the Fund, so that they would become a permanent part of the quota structure and the Fund's right to borrow from the Group would be unconditional to the extent of the Group's total commitment. Moreover, we regret that the General Arrangements To Borrow gives any member veto power over the admission of new members. We have already expressed our preference for broadly based, nonexclusive financial arrangements. In any event, the amount of funds which each member of the Group conditionally agreed to provide under the 1962 General Arrangements To Borrow seems to us to correspond to the amount by which the member's permanent quota in the Fund should be increased. In general, we would regard the need for Fund borrowings from a country or group of countries, and especially the need for such borrowings to be outstanding for any length of time, to be prima facie evidence that the country or group of countries concerned should accept increased Fund quotas. It should be an objective of United States policy to achieve a better sharing of international financial responsibilities among countries through an improved structure of Fund quotas.

**11. The present system of bilateral arrangements as a second line of defense against short-term instability, while not the solution to long-term liquidity needs, should be expanded.**

The development of swap arrangements and the sales of "Roosa" bonds have contributed significantly to stability. They have limited gold flows resulting from short-term capital movements and reduced the "overhang" of dollars. The present network of swaps and the proved willingness of countries to provide rapid and large-scale emergency assistance even without the prior negotiation of swaps, serve as a warning to speculators that the overwhelming monetary assets of leading financial powers will be turned against them if they try to break a major currency.

We regard it as unnecessary to make these limited ad hoc arrangements a formal part of the IMF. As a second perimeter of defense, they provide speed and flexibility difficult to institutionalize in a multilateral agency. They do not detract from the Fund's primary short- and long-term responsibilities. We believe that the present network of swaps and special foreign currency bonds, involving mainly United States arrangements with other countries, should be extended to arrangements linking other countries with each other.

At the same time, we must recognize the limited role which, at best, such arrangements can play. They provide limited short- and medium-term assistance and safeguard the system against disruption through speculation. But they do not contribute to long-term liquidity needs. The answer to these needs lies in the creation of new reserve assets and the expansion of the conditional credit facilities of the Fund.

**12. International financial reforms, however desirable, are not sufficient. Substantial improvements are needed in the adjustment process which brings international payments imbalances to an end.**

International liquidity is essential in a system of fixed exchange rates, because all nations are subject to temporary deficits in their international payments and must rely on reserves or credit facilities to finance these deficits. The longer and more severe the payments imbalances, the greater is the need for liquidity. But no amount of liquidity would suffice if payments imbalances were not brought to an end. The proper role of international liquidity is, to quote the Fund's Articles of Agreement, to allow countries "to correct maladjustments in their balances of payments without resorting to measures destructive of national and international prosperity."

In the heyday of the gold standard, before 1914, adjustment to payments imbalances was accomplished fairly smoothly through the operation of free market forces. Gold flows from deficit to surplus countries resulted in price, income, and interest rate changes which restored equilibrium by improving the deficit countries' trade positions and attracting foreign capital. This system was disrupted by the First World War and the difficulties that followed.

Increasingly, national governments have come to assign higher priorities to the achievement of domestic objectives—maximum employment, price stability, and economic growth—which, under the international gold standard, frequently had been sacrificed to international objectives. Rigidities in the structures of industrial economies, caused by the pricing and employment policies of business and agricultural policies of governments, sharpened the competition

between domestic and international objectives. To a growing degree, adjustment infringed on levels of employment and real wages. Governments therefore began to insulate their domestic economies from international economic influences. At the same time, exchange rate adjustments, contemplated in the Fund's Articles of Agreement as the appropriate remedy for fundamental disequilibria, have fallen into disuse. International payments imbalances have consequently tended to persist and to strain existing financial mechanisms. Deficit countries have increasingly used selective measures affecting particular categories of international transactions to choke off their international deficits, while surplus countries often follow policies that tend to perpetuate their surpluses.

We conclude that improvements in the adjustment process are urgently needed. Financial improvements alone cannot produce a stable international economic system. In its 1964 report on the United States Balance of Payments, the Joint Economic Committee found that "a clear distinction must be maintained between the need to promote adjustment to international imbalance and the problem of international liquidity" and that "international equilibrium is the responsibility of all nations—surplus as well as deficit countries." The committee further concluded that "the surplus countries must play a larger role in the adjustment process," that "surplus countries, like deficit countries, must pursue domestic policies with a view to the balance of payments," and that "surplus countries must abandon policies which hinder the elimination of international imbalances."

We refer our readers to the 1964 report for a full statement of Joint Economic Committee findings and recommendations with respect to adjustment policies. In our present report, we emphasize the following:

***A. We must work toward an improved system for harmonization of national fiscal and monetary policies.***

Nations have made significant progress in harnessing monetary and fiscal policies for the achievement of domestic goals. Widespread understanding exists also concerning the potentials of these policies for international equilibrium, but their application for this purpose has been uneven among nations. The contrast is especially sharp between balance-of-payments deficit and surplus countries.

The United States, for example, has attempted to use an expansive fiscal policy to realize domestic objectives of growth, price stability, and maximum employment, while raising short-term interest rates to attract foreign funds and keep domestic funds at home. Reasonable men may differ as to whether the United States has achieved the optimum mix of policies. But there is little room for disagreement on the conclusion that some European surplus countries have resorted to a clearly inappropriate combination of monetary and fiscal policies. In the face of inflationary conditions at home, they have raised interest rates and some have even cut taxes. They should have done the opposite—reduced interest rates to discourage capital inflows and encourage outflows, and raised taxes to curb inflationary pressures. These inappropriate policies have greatly intensified the difficulties of adjustment. In recent years, the monetary policies of

the leading countries have been more competitive than complementary. Even when the United States raised short-term interest rates, interest differentials were not permitted to narrow in several instances because certain countries again raised their rates.

We have made significant progress in improving international consultation and cooperation on economic affairs. But here, clearly, is an area where much further work remains to be done. Nations should not work at cross purposes in their monetary and fiscal policies. We urge that an improved system for harmonizing such policies be developed, under the aegis of the IMF and the OECD.

***B. We should agree with other countries upon codes of national behavior with respect to restrictions on capital movements for balance-of-payments reasons.***

The principal advantage of a fixed exchange rate system is that it encourages larger international flows of trade and capital movements than any system in which exchange risks are present. We favor a world of expanding trade and capital movements. All nations benefit from international specialization and the ability to buy and sell in growing world markets. International capital flows can promote world trade, spread the benefits of modern technology among nations, foster economic growth, and benefit both the countries making and receiving the investments. It is one of the many ironies and inconsistencies of modern life, that, to protect fixed exchange rates—the means—we have compromised freedom of capital movements and, to some extent, of trade—the ends which the fixed rates are intended to serve.

There may be circumstances when restrictions on capital movements are the best—least worst—response to a difficult problem. As we make further progress toward international cooperation, as countries work together more effectively to promote adjustment, these circumstances will become rare. But until this further progress is realized, we consider it desirable to achieve agreement on the principles governing the use of restrictions on capital movements for balance-of-payments reasons.

Such agreement is desirable for the same reasons as underlie our recommendation for better coordination of monetary and fiscal policies: all countries should work together for a better adjustment process; none should work at cross purposes with the others. We already have a set of rules in the General Agreement on Tariffs and Trade governing the application of trade restrictions. The Fund provides rules concerning exchange rate stability and the avoidance of discriminatory currency practices and restrictions on current payments; it does not regulate restrictions on capital movements. But in this area, no less than in the others, we need to develop standards. We continue to seek freedom for international capital transactions, as well as for trade, as our basic longrun objective. We must not preclude ultimate attainment of this objective by permitting the gradual, uncontrolled growth of an underbrush of capital controls. Moreover, we must prevent the use of capital restrictions that operate unduly to the detriment of other nations.

Some progress toward agreed-upon rules of conduct in international capital restrictions has already been achieved through the code of

liberalization of capital movements negotiated within the OECD. This work in the OECD could be extended to the establishment of general principles and priorities to govern the use of restrictions on capital movements for balance-of-payments reasons. Agreement may be possible that, when restrictions on capital movements are necessary, indirect measures which retain scope for market forces, such as interest equalization taxes, are preferable to direct measures which do not, such as exchange controls; that restrictions on capital movements are preferable when they retard short-term funds in search of higher interest rates than when they retard funds used to finance trade or the construction of plant and equipment abroad. The achievement of standards along these lines should be an objective of United States policy.

***C. The advantages and disadvantages of widening the permissible limits of exchange rate variation must be examined thoroughly as an essential part of a comprehensive program for improving the international monetary system.***

The Joint Economic Committee, in its 1964 report on the balance of payments, recommended that "The United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange rate variation." It cited these advantages in support of its recommendation:

(a) It would permit the monetary authorities greater freedom to pursue independent monetary policies without providing incentives for short-term capital movements; the authorities would have greater scope for short-term intervention in the forward exchange market to offset interest-rate differentials.

(b) It would permit exchange rate variations to play a somewhat larger role in the adjustment process than is now possible.

(c) It would discourage speculation by increasing the risk of losses in relation to the possibilities for profit.

In its 1965 Joint Economic Report, the committee again urged the study of this idea. It stated that "consideration is especially appropriate at this time, when short-term capital movements have intensified our balance-of-payments difficulties." Again citing the advantages of broader exchange rate variations, the committee concluded:

These advantages are so relevant to our present needs, and the proposal so evolutionary in character, that a careful exploration of offsetting disadvantages, if any, further implications, and practical problems of implementation, is called for. We must leave no stone unturned in a search for improvements in the international monetary system which would permit greater freedom for international transactions, increase the ability of monetary and fiscal policies to focus on the achievement of domestic objectives, and at the same time strengthen the forces operating to restore international financial equilibrium.



The Banking and Currency Committee of the House, in its April 1965 report on increasing the IMF quota of the United States, also endorsed consideration and study of broader limits for exchange rate variation. Referring to this idea, the House committee stated:

\* \* \* It raises the possibility that, within the framework of the present structure of exchange rates and without unduly increasing the risks of international transactions, monetary policy would better be able to serve domestic needs, speculative capital movements would be discouraged, and imports and exports would be affected in such a way as to reduce international payments imbalances.

More than a year has elapsed since the Joint Economic Committee recommended exploration of this idea by the administration, but we are unaware that any such exploration has occurred. To ignore promising proposals for improvement would appear to us a luxury which the free world can ill afford. We do not insist that broader limits for exchange rate variation be adopted, for we have not fully explored their implications nor weighed any possible disadvantages against the benefits we recognize. But we do insist that the expertise of the administration be brought to bear on the idea and that it receive the serious consideration which it merits. We will ask for a full statement of the administration's position concerning this idea on the occasion of our next hearings on progress toward an improved international monetary system.

What are the disadvantages of broader exchange rate limits? Are there any, or is it simply that the idea is at variance with the current preferences of central bankers? We do not seek change for the sake of change, and would not lightly recommend that current practices be altered. But if inconsistency with current practices were sufficient reason to oppose change, we would never progress.

Exchange rate variations were a normal part of the pre-World War I gold standard. At that time, exchange rate stability was maintained not by government intervention in foreign exchange markets, as is the case today, but by the actions of private traders and dealers who found it profitable, at certain exchange rates, to buy and ship gold abroad rather than buy foreign currencies. The amount of deviation from parity values possible under this system was defined by the costs of shipping and insuring gold, and by the time required for transportation. These considerations established the so-called gold points within which exchange rates were free to vary. The role of governments was limited to buying and selling gold at fixed prices.

An important feature of this gold standard was that the exchange rate variations it permitted promoted capital movements that reduced international payments imbalances and thus promoted stability. So great was confidence in the maintenance of exchange rate parities, that a modest decline in market exchange rates induced capital movements by speculators who expected to profit from a future strengthening of the rates. Confidence in exchange rate stability was essential to make the system function smoothly. When this confidence was destroyed, as a result of the dislocations that followed the First World War, capital movements became disruptive and added to international imbalances.

Exchange rate variations were made a formal part of the post-World War II system in the Fund's Articles of Agreement. These articles provided that variations of spot rates are to be no more than 1 percent on either side of parity. As a matter of choice, the European countries limit their rate variations to around plus or minus three-fourths of 1 percent of parity. Some have adopted an even more restricted view. When one of the European countries was in balance-of-payments difficulties several years ago and its exchange rate was under pressure, the monetary authorities chose to support their currency near the upper limit rather than let the rate sink somewhat and allow market forces to help restore balance. We find it difficult to understand why such a course should have appeared desirable. In general, full use of such flexibility as is now permitted would appear to be the best course.

Limited exchange rate flexibility is a feature of today's international monetary system, as it was of the gold standard to which some look back with nostalgia. Such flexibility is obviously compatible with a system of pegged exchange rates. An impressive record of exchange rate stability among major currencies has been achieved since the Second World War. With such a record, the time may now be ripe for a modest broadening of the present limits of exchange rate variation so that we may more fully avail ourselves of the benefits already described. We again strongly urge that the administration carefully and seriously consider this idea and determine its potential for contributing to an improved international monetary system.

## VI. NEGOTIATING STRATEGY

We strongly support the administration's decision to move without delay toward an international monetary conference. We agree with Secretary of the Treasury Fowler's general comments concerning the United States approach to such a conference made in his speech of July 10, 1965. Mr. Fowler said:

I am privileged to tell you this evening that the President has authorized me to announce that the United States now stands prepared to attend and participate in an international monetary conference that would consider what steps we might jointly take to secure substantial improvements in international monetary arrangements. Needless to say, if such a conference is to lead to a fruitful and creative resolution of some of the free world's monetary problems, it must be preceded by careful preparation and international consultation.

To meet and not succeed would be worse than not meeting at all. Before any conference takes place, there should be a reasonable certainty of measurable progress through prior agreement on basic points.

Our suggestion is that the work of preparation be undertaken by a preparatory committee which could be given its terms of reference at the time of the annual meeting of the International Monetary Fund this September.

We would add only two suggestions:

**1. All members of the Fund should be eligible to participate in the Conference.**

We have already recommended that all qualifying Fund members should benefit directly from new reserve creation, and that new arrangements for increasing international liquidity should be carried out through the Fund. It follows that the proposed conference should be open to all Fund members. Clearly this is no exclusive formula to limit benefits to a group of insiders. Fund membership is open to all countries who wish to join and adhere to its Articles of Agreement. The road to participation in the Conference is thus open to any country wishing to take part.

**2. Decisions at the Conference should not require unanimity.**

Unanimity should neither be required nor, beyond reasonable limits, sought. If unanimity is the rule or practice, the price of agreement may be extortionate; the most intransigent negotiator can exact concessions in return for his consent which so qualify the final agreement that it is scarcely worth achieving.

In some matters, minorities are properly not bound by majority vote. In such cases they are free to participate or not as they choose. But often the majority should go its way. It may be better to have a meaningful agreement at the price of incomplete participation than an empty agreement that has been made acceptable to everyone.

